

Visit note

BHEL

SELL

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We met the BHEL management to get an update on the company's capacity expansion plan and learn more details about the FY07 result. We also met Dongfang Electric Corporation's India representative recently to get an understanding about the intensity of competition in the Indian power equipment market and Dongfang's plans for the Indian market.

Meeting with BHEL

The key points that came out of the meeting were:

- There has been a one-time hit of about INR 2,200m in Q4FY07, due to an increased provisioning for post-retirement medical benefits for employees
- The positive impact of about INR 1,800m that the company had in Q3 is also one time in nature and arose from some corrections made for previous quarters
- The margins in FY07 were flattish YoY for the power segment but there was a slight increase in the industrial segment margins
- The company is confident of meeting its guidance of 30% topline growth in FY08 and said that margins for FY08, at worse, would be similar to FY07 levels
- The capacity expansion to 10,000MW per annum is on track and is expected to be completed by 2007-end

Meeting with Dongfang Electric Corporation

Company introduction

Dongfang Electric Corporation, the largest power equipment manufacturer in China, has annual manufacturing capacity of 20,000MW. The company, with supercritical boiler technology from Hitachi, has installed or is installing 100 600MW supercritical units in China. It also manufactures ultra supercritical units of 1,000MW.

Plans for the Indian market

Dongfang is aggressively targeting the Indian market as the Chinese market is expected to see a surplus capacity of about 20,000MW from 2008. The company has so far been targeting private players. It has not scouted business from the State Electricity Boards (SEBs), which is more lucrative in nature. Dongfang is confident of the short-term opportunities in India. In the long term, the company is cautious in its approach and considers L&T as a major threat in the area of supercritical technology. Dongfang is also planning to set up a service centre in India.

Quality issues and pricing

The company is confident of the quality of its products. **Our research shows that Chinese power stations are operating at 76% plant load factor (PLF), which confirms favourably with India's average PLF of 75%.** Dongfang said that its pricing was 10% lower than that of BHEL. Note that Dongfang's pricing would be 25% lower than that of BHEL, if we also consider the rates at which BHEL supplies to the SEBs. The company also said that its Sasan Ultra Mega Power Projects pricing was not an entry pricing and that it is at par with the pricing levels in China. It also added that the equipment prices in India are lower than other countries except China. This rules out any direct competition for BHEL from non-Chinese players like Doosan and European companies.

Conclusion

We expect competition from the Chinese players and also from L&T to heat up from FY09, when orders for the 12th plan will begin to be placed. This competition will be largely in the supercritical technology area. With large number of supercritical units being planned for the 12th plan, we expect BHEL's margins to decline as it would not have a monopoly, which it enjoys in the sub-critical area. Here we should point out that the margins of 19%-plus are more or less secured till FY09 as the current order book will be executed by FY09. These orders would have been secured at current margin levels.

If we account for the two one-time impacts, the estimated FY07 margin for BHEL would be 19.3% as compared to our expectation of 19.1%. We would wait for the final results to be announced before making any changes to our estimates and the price target.

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